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FORTUNE

Now that the oldest of them are about to turn 40, the free-spending baby-boomers are changing their buying habits. Keith Bendis drew the cover illustration. For the boomers' latest desires, see page 28.

LOOKING AHEAD

What the Baby-Boomers Will Buy Next 28
They want good furniture, expensive suits, convenient and nutritious food—and champagne. *by Geoffrey Colvin*

THE ECONOMY

Why You Can't Love the Deficit 39
Economists who argue it doesn't matter are wrong. *by Bruce Steinberg*

Fortune Forecast:
- **Growth Will Slow—But Not Too Much** 48
- **Housing Turns Down** 49

CORPORATE PERFORMANCE

Ma Blue: IBM's Move into Communications 52
Big Blue hopes to spur demand for computers by helping them talk to each other. *by Richard I. Kirkland Jr.*

MANAGING

Eight Big Masters of Innovation 66
Exploiting new ideas takes discipline. And fear. *by Stratford P. Sherman*

In Praise of Cluttered Desks 89
A clean one usually means somebody else is in charge. *by Harold S. Geneen*

SELLING

Advertisers Show Signs of Football Fatigue 141

Goldstar's U.S. Debut 141

Selling Software on the Honor System 146

TECHNOLOGY

Japan's Persistent Software Gap 150
Catching up isn't easy. *by Bro Uttal*

Austin, Texas, on a High-Tech High 164
It's luring companies that need first-rate scientific talent. *(A picture portfolio)*

MONEY & MARKETS

The Thrift Industry Is Under Siege Again 175
If interest rates don't ease, hundreds of thrifts could soon fail *by Gary Hector*

New Issues: Who Underwrote the Lemons 189

Europe's Easy Money 190

POLITICS & POLICY

Time Bombs in the 1984 Tax Act 195
Buried inside is bad news for employee benefits. *by Maggie McComas*

Business Doesn't Buy Mondale's Deficit Plan 205

Pinching on Government-Backed Loans 205

Richard Allen's Preemptive Strike 206

PROFILE

Jerry Sanders's Act Is Cleaning Up 210
The high-living chairman of Advanced Micro Devices really is a conservative businessman. *by Gene Bylinsky*

People to Watch 220

LABOR

Did GM Give Away the Store? 223
No. Wages will climb, but the company has the freedom to automate its plants. *by Steven Flax*

The Editor's Desk 4

News/Trends 6
The UAW and GM, Reagan finesses steel, musical chairs in Hollywood, and more.

Follow-Up 9
High-tech exports, score one for junk mail, and more.

Letters to Fortune 13

Keeping Up 231
by Daniel Seligman

Personal Investing 239
Supermarket stocks. The Korea Fund. Regional stocks. Portfolio Talk: Investment strategist Michael Sherman.
by John J. Curran

Other Voices 249
Business should back Mondale.
by S. Lee Kling

On the Road 255
Yankee cooking abroad.

Books & Ideas 263
The good life in Russia.
by Daniel Seligman

Index 270

Office Hours 273
Beyond sexist management.
by Walter Kiechel III

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LETTERS

er, here in Mexico we face problems greater than your bosses probably have ever faced. Were we to produce such paltry returns on stockholders' equity, I should probably resign.

The people you mention may be highly intelligent, but they are not "smart." The way to get on with people is to treat them with respect. A cardinal rule should be that if you have to give a reprimand it should be done in private. The ten people you describe may be serving their egos, but they are not serving the people who have given them their positions and exorbitant incomes.

G. ANTHONY M. BUTT
Managing Director, Probst S.A.
Naucalpan de juárez, Mexico

Wish List

In "Life After the Lottery" (September 3) I was surprised to find that most of the big-ticket lottery winners maintain a low profile. As I see it these winners don't make the most of their megabucks.

Here's what I would do if I won a million dollars in a state lottery: Tell my boss to "take this job and shove it." Tell my wife to tell her boss the same thing. Take my wife and two boys on a three-month tour around the most beautiful spots in the world. After traveling, buy two homes in the U.S. One on the West Coast, and one on the East Coast, beachfront property a must. Buy two new automobiles and an airplane. Start my own doughnut shop franchise—first locally, and then nationally.

JAMES D. HUNTLEY
Santee, California

Corrections

The box accompanying "Why Directors Can't Protect the Shareholders" (September 17) mistakenly said that several of Pneumo Corp.'s outside directors resigned last year in a dispute with management over whether to sell the company's retail operations. Pneumo's sale of its retail businesses was never formally brought before the board, and no directors resigned. The same story erroneously reported that when Harold Geneen's group sold its shares in George A. Fuller Co., it barely broke even. The Geneen group earned 250% on its equity investment and 34% on its debt investment in 2½ years.

"Hard Sell Comes to Software" (September 17) incorrectly referred to Innovative Software as a private company. Innovative went public a year ago and is traded over the counter.

The FORTUNE directory of the 500 largest industrial corporations outside the U.S. (August 20) included several incorrect figures for Alcan Aluminium. The correct figures are: sales, $5,208,000; assets, $6,600,000; net income, $73,000,000; stockholders' equity, $2,799,000.

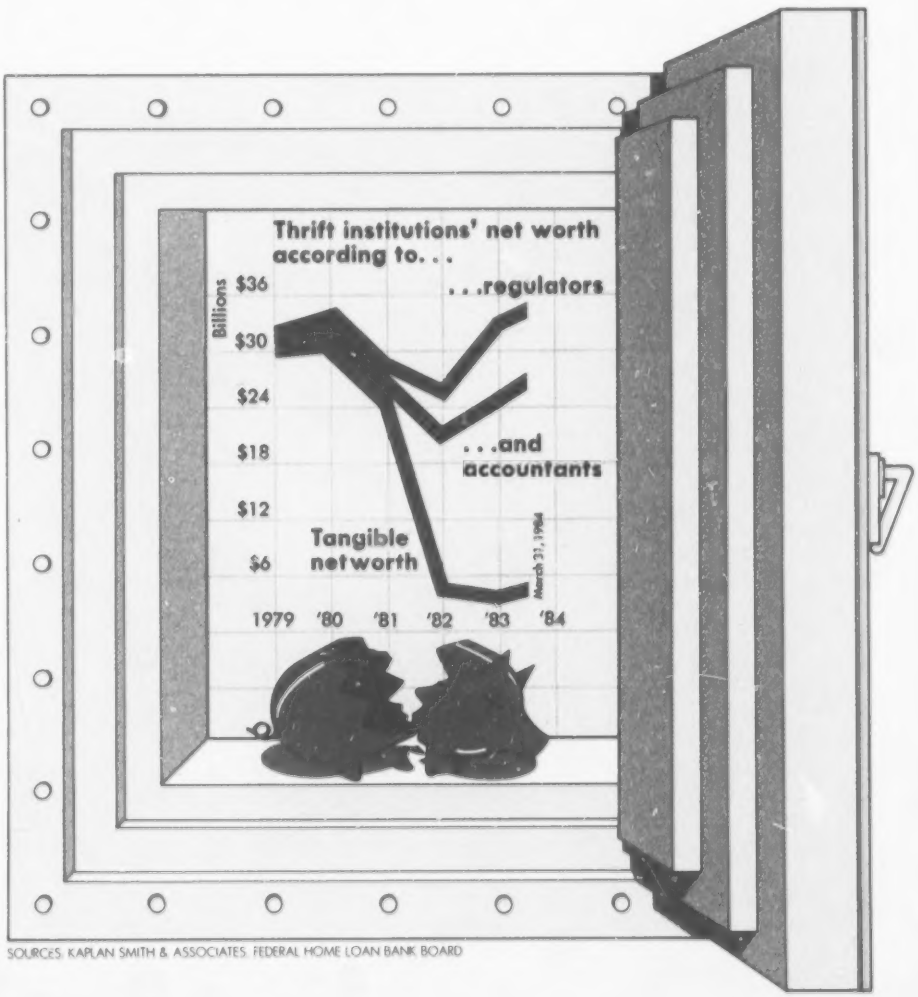
The directory should also have listed the end of Swedish Match's fiscal year as December 31, 1983.

THE THRIFT INDUSTRY IS UNDER SIEGE AGAIN

With their financial strength decimated by the interest-rate onslaught of 1981 and 1982 and their earnings now vanishing, savings institutions are living on accounting illusions and prayers that today's high rates will ease. If they don't, hundreds of thrifts could soon fail. ■ *by Gary Hector*

THE LATEST CRISIS for the nation's savings institutions extends far beyond the run that recently crippled Financial Corp. of America, the largest such institution in the U.S. For almost four years federal regulators have sanctioned accounting gimmicks that make the weak balance sheets of savings and loans and mutual savings banks look almost healthy. But the industry is nearly as feeble now as it was two years ago, after skyrocketing interest expenses had driven 780 thrift institutions into merger or liquidation. And as regulators survey the damage from the latest run-up in interest rates, they see no choice but to employ more gimmicks while hoping for rates to subside or for deep-pocketed acquirers to rescue shaky institutions.

The thrifts have not rebuilt their strength as fast as regulators had hoped. They have made maddeningly little progress in girding against their greatest danger, a rise in short-term rates. Their total net worth, when stripped of such dubious bookkeeping items as goodwill, is down sharply from three years ago (see chart). And although interest rates are well below



SOURCES: KAPLAN SMITH & ASSOCIATES, FEDERAL HOME LOAN BANK BOARD

Weaker Than They Look

Regulators accept accounting gimmicks that make the savings and loan industry's net worth appear robust of late, and it hasn't slipped much when measured by generally accepted accounting principles. But subtracting goodwill leaves an anemic level of tangible net worth. All three numbers will worsen unless interest rates fall significantly.

ILLUSTRATION BY ROGER GORMAN

their 1981 peak, when the prime rate soared to 20.5%, the industry is barely earning a profit. "Absent a real rate improvement," says a Wall Street economist, "it's going to get fairly dicey." While fewer than a dozen of the nation's 3,500 thrifts have failed this time around, he says, hundreds more could.

Still on the books are warehouses full of fixed-rate, long-term mortgages made years ago when interest rates were much lower, plus a raft of new fixed-rate loans made last year before rates crept up again. Thrifts are bidding against banks and money market funds for consumer savings, paying market rates on deposits and dishing out more to depositors than they take in on those mortgages. There's no quick way to end this pain. The savings institutions can't unilaterally pay lower interest rates on deposits, since savers would bolt, forcing them to liquidate part of their loan portfolios. Few thrifts are financially strong enough to sell off the old mortgages in any case. When interest rates started leaping back in the late 1970s, the fixed-rate mortgages collapsed in value but were kept on the books at face value. To sell those mortgages at today's rates would be to take staggering write-offs.

"Unless interest rates drop appreciably by mid-1985, the percentage of savings institutions in serious trouble could equal the worst days of mid-1982."

DAVID W. GLENN
Past director, Federal Savings & Loan Insurance Corp.

IF INTEREST RATES STAY at recent levels, with the prime at 13%, the thrift industry will be losing bucketfuls by year-end. The delayed effect of higher rates will slowly pinch earnings as six-month and one-year certificates of deposit mature and are replaced by certificates at today's rates. Worries David W. Glenn, past director of the Federal Savings & Loan Insurance Corp., which insures deposits at most S&Ls: "Unless interest rates drop appreciably by mid-1985, the percentage of savings institutions in serious trouble could equal the worst days of mid-1982."

The choices open to regulators are few. They can't bail out thrifts en masse or absorb the expense of liquidating them and meeting their uncovered obligations. The $23 billion in the nation's deposit insurance system wouldn't begin to pay the bill. "Until interest rates come down," says D. James Croft, formerly director of the Federal Home Loan Bank Board's office of examination and supervision, "the only realistic strategy for the regulators is to buy time." That's what the FHLBB, which regulates savings and loans, has been doing over the past four years. While commercial bank regulators have been pressing banks to increase capital as a cushion against the heightened risks brought about by deregulation, the FHLBB has been moving in the opposite direction with the weaker thrift industry, loosening capital requirements and accounting procedures to keep many S&Ls from failing.

Although interest rates dropped in 1982 and 1983, they didn't drop enough for S&Ls to score big profits and boost their capital. In its best showing, during the first half of 1983, the industry earned money at a lackluster annual rate of 30 cents on every $100 of assets. A third of the nation's thrifts never regained profitability during 1983. By the first quarter of 1984, the return on assets had dropped to less than 16 cents per $100 of assets and by the end of the second quarter the industry was just breaking even.

Regulators aren't sure what will happen if rates remain high. In 1981 and 1982 the vast majority of troubled thrifts were saved through mergers with stronger institutions. But creative accounting played a part, along with a lot of government help. In many mergers, Washington guaranteed a minimum return on the acquired thrift's mortgages, took over problem loans, or put up money.

But last year the kill-joys in the accounting industry rewrote the rules for acquisitions, taking away a big incentive for buying a floundering thrift. Now it's likely that when the FSLIC or the Federal Deposit Insurance Corp., which regulates mutual savings banks, steps in to force a merger, the government will have to pick up more of the bill. And the failures produced by a year of high rates could easily strain the nation's deposit insurance system. Says Edwin J. Gray, chairman of the FHLBB, "The losses that we are seeing and can reasonably foresee down the line are causing a steady and significant deterioration in the [S&L] insurance fund's level."

The heart of the problem is the industry's vulnerability to rising short-term rates. A few large S&Ls, including subsidiaries of such publicly traded giants as Great Western Financial Corp. and H.F. Ahmanson & Co., both of Los Angeles, have dramatically improved their balance sheets by writing reams of adjustable-rate mortgages, whose rates can be changed every six months or so. But the industry as a whole, most of it depositor-owned mutual institutions, has made disappointing progress. Faster than the thrifts could write adjustable-rate mortgages, depositors pulled billions of dollars out of low-interest savings accounts and stuffed them into newly created short-term deposits—money market accounts and CDs—paying higher and variable rates of interest.

ONE IMPORTANT measure of the industry's exposure is its short-term interest rate gap. Essentially the gap compares the loans and deposits on which rates are likely to change within a year. If interest-sensitive deposits exceed loans in this calculation, then when interest rates rise, the industry's costs will rise faster than income, putting a squeeze on profits. The larger the

RESEARCH ASSOCIATE *Rachael Grossman*

gap, the more deadly the squeeze. And the industry's gap is nearly as large as in late 1981, when a spike in interest rates inflicted widespread losses.

Estimates by Kaplan Smith & Associates, a consulting firm, show that the gap was equal to about 38% of total thrift assets at the end of March, almost unchanged from the end of 1981. Thrifts have belatedly attacked the gap, furiously issuing adjustable-rate mortgages. But they still have a long way to go.

Once the industry starts to lose money, its capital could rapidly disappear. As figured by regulators, the nation's S&Ls as a whole have net worth equal to about 4% of their liabilities. In the 1970s, when the industry was heavily protected by regulation, including artificially low ceilings on the interest thrifts could pay on most deposits, regulators flew into a rage if an institution's net worth dropped below 5%. Today's 4% figure, moreover, is puffed up by accounting gimmicks. One is capital income certificates, paper capital created by regulators in exchange for a low-interest long-term note from a troubled thrift. Another is deferred losses on securities, a bookkeeping entry that allows S&Ls to spread their realized losses on securities transactions over several years.

The biggest and most questionable accounting item, though, is goodwill derived from the takeovers of troubled thrifts. Goodwill is an accounting concept used when one company pays a premium over market value for another. In recent thrift mergers, the goodwill created when one S&L bought another was mainly the excess paid over market value for the acquired thrift's mortgages.

Almost no one argues that goodwill is valueless—among other things, the loyalty of consumers to a specific S&L is worth quite a bit. But goodwill is not the stuff of which solid financial institutions are made. Without the accounting mush—mainly goodwill—the thrift industry has a disconcertingly small core of hard capital. On March 31 the S&Ls insured by the FSLIC had $34 billion of net worth as far as regulators were concerned. Subtracting such items as deferred losses and capital income certificates, which aren't considered capital under generally accepted accounting principles, cuts the industry's capital on that date to about $27 billion.

"The losses that we are seeing and can reasonably foresee down the line are causing a steady and significant deterioration in the [S&L] insurance fund's level."

EDWIN J. GRAY
Chairman, Federal Home Loan Bank Board

THE REALLY DRASTIC shrinkage comes when goodwill is excluded. Most of it, or about $20 billion, results from S&L mergers of the past three years. What's left after subtracting goodwill is tangible net worth—a sum of $4.5 billion, or about 0.5% of S&Ls' liabilities at the end of March. That core of capital, including cash and buildings, is concentrated among a dozen or so institutions, including those that raised about $2.7 billion in cash through public stock offerings last year. Some leading institutions' net worth is a negative figure (see table). Many S&L executives minimize the importance of tangible net worth, arguing that it greatly understates their core capital.

What counts in the end is not the state of S&L balance sheets but what depositors and investors think. Depositors could lose faith and exit from thrift accounts, while investors could desert S&L stocks, causing them to plunge. Neither has happened yet. "The public doesn't care if the S&Ls don't have any net worth," says Paul Horvitz, a professor of finance at the University of Houston who sits on the board of the Federal Home Loan Bank of Dallas. As long as there is no run on the S&Ls, says Horvitz, "we can stall for a long time, keeping the institutions alive with funny accounting if necessary."

Since the public isn't edgy, regulators are free to engage in hocus-pocus. The FHLBB and FSLIC developed these strategies in the dark days of 1980 and 1981 under Richard Pratt, then chairman of the FHLBB. The agency didn't just allow S&Ls to cook the books, it handed out cookbooks.

AMONG ITS MORE fascinating recipes was a technique for turning goodwill into paper profits. A brief example illustrates the metaphysical possibilities. One S&L acquired another, in the process obtaining a 9% mortgage with a face value of $100,000. Mortgage rates had risen since the mortgage was originally issued, so it was now worth only $80,000. The $20,000 drop was recorded as goodwill, which is slowly written off over 40 years as an expense. Meanwhile, though, the mortgage creates an offsetting stream of added income as it is paid off in full over the years. The income flows in faster than the expense—a typical low-interest mortgage has 15 years to go until maturity—leaving the thrift with a nice reportable profit.

One beneficiary of this procedure is Home Federal Savings & Loan of San Diego. Last year the write-up of acquired mortgages, after subtracting for the charge-off of goodwill, accounted for a third of Home Federal's $34 million of net income. The catch is that long after the mortgages have been written up, the thrift will have to go on writing down goodwill, making its earnings look worse later on.

Accountants decided last year that the divergent periods for recording these items were too fictitious for their taste. The Financial Accounting Standards Board didn't change the accounting for mergers completed in the past, or for new takeovers of healthy thrifts. But where shaky ones are involved, it now requires that the income and expenses related to goodwill be spread over the same period of time. That's one

of the accounting changes that is making it harder for regulators to unload failing thrifts.

Meanwhile, the FSLIC has been whipping up another accounting delicacy: a proposed redefinition of insolvency. Under current regulations, an S&L is considered insolvent when its net worth drops to zero. But there's a strong probability that such a definition would force the FSLIC to prop up far too many S&Ls if interest rates stay high. So the agency wants to focus more attention on an

How the Top Ten S&Ls Measure Up

For most of these institutions, all publicly traded either directly or through parent companies, net worth as defined by regulators differs little from the figure reported to the Securities and Exchange Commission, based on accounting principles. But many of the ten carry whopping amounts of goodwill from acquisitions, and subtracting it leaves four with a negative tangible net worth. All S&Ls shown here, except First Federal of Michigan and City Federal of Elizabeth, New Jersey, are based in California.

SAVINGS AND LOAN INSTITUTION Parent company	ASSETS 3/31/84 in millions	NET WORTH AS REPORTED TO... ...THRIFT REGULATORS in millions	...AND THE SEC in millions	TANGIBLE NET WORTH in millions
American Financial Corp. of America	$25,048	$1,001	$917	−$177
Home Savings of America H.F. Ahmanson & Co.	$20,787	$795	$720	$332
Great Western Federal Great Western Financial Corp.	$18,834	$795	$790	$785
California Federal	$14,727	$813	$772	$102
Glendale Federal	$9,695	$600	$600	−$213
First Nationwide Federal First Nationwide Financial Corp.	$8,673	$299	$278	$277
First Federal of Michigan	$8,445	$224	$200	$163
World Golden West Financial Corp.	$8,183	$277	$277	−$111
Home Federal	$6,981	$572	$572	$386
City Federal	$6,754	$271	$270	−$6

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S&L's ability to generate cash. As long as an S&L is generating enough money to pay its bills, the FSLIC wants the option to ignore its problems. This radical proposal leaves traditionalists fuming. Says a bank regulator, "Financial institutions have to have some equity; that's the price of admission. Anyone who says equity is irrelevant and cash flow is the key is rationalizing."

Whatever accounting gimmickry the regulators indulge in, the ultimate success of their delaying action will depend on how well thrifts succeed in pulling up their profits. In 1982 Congress granted broader powers to most thrifts, allowing them to start making commercial loans and to become more active as real estate developers. If the last two years are any measure, though, it will be at least 1990 before these diversification efforts begin contributing a sizable share of profits. The risks of these new ventures, moreover, could catch up with the S&Ls before the profits start to flow.

What gives regulators nightmares is that somewhere out there in the world of thrifts a chief executive may be trying to restore his institution's health with a big win on a high-risk investment. "A lot more people are going to be encouraged to take desperate gambles," says ex-FSLIC chief Glenn. "If they lose, the government will have to pick up the tab. And if they win they get to keep their jobs and their stock options."

The most important step that thrifts can take now is to jump on the bandwagon in issuing adjustable-rate mortgages. Even these aren't foolproof. The interest rates on about half the adjustable mortgages now being written can rise no more than two percentage points a year, leaving thrift profits vulnerable should interest rates suddenly spurt.

SOME S&Ls, most notably World Savings in Oakland and First Nationwide in San Francisco, are turning to the religion of getting expenses under control. Herbert Sandler, World's chairman, estimates that his S&L's overhead as a percentage of assets is 1.1%, about half a percentage point lower than the average for the country's eight largest S&Ls.

Such feats are likely to be the exception. For most of the industry, few low-risk solutions are available. In deregulating the world of banking, Congress almost ensured that large numbers of thrifts would fold. Congress isn't yet prepared to turn back the clock on deregulation, so regulators are sticking to the plan, leaving plenty of room for institutions to get out of the thrift business, either by diversifying or failing.

Disappearance of the sickest third of the industry seems inevitable. Thrifts that are still fairly healthy, but might not remain so, need financially strong acquirers whose capital can tide them over until those old mortgages expire. Commercial banks in quest of wider customer bases would seem the most appropriate buyers. But the laws allow banks to acquire only failing thrifts. Congress needs to allow all comers, including banks and nonfinancial corporations, to buy healthy S&Ls, but seems in no hurry to do so. Yet if it waits too long, some S&Ls may weaken so greatly as to scare off buyers.

While some might mourn the absorption of the neighborhood S&L into an impersonal conglomerate, this solution seems preferable to another alternative: allowing the thrifts to combine into bigger—but not necessarily stronger—units. The government's strategy of stalling, instead of encouraging takeovers from outside the thrift industry, amounts to a Micawberish bet that lower interest rates will come along and save the S&Ls from their troubles.

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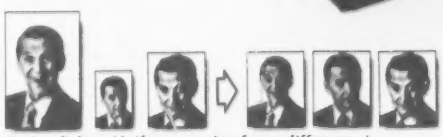

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NEW ISSUES: WHO UNDERWROTE THE LEMONS

Of the 30 firms that brought out the most new stock issues last year, only one sold investors more winners than losers.

SHARES IN COMPANIES going public for the first time were the hottest merchandise in the 1983 bull market—and many investors got burned. Now that most of those new issues have been trading for a year, what do the results tell investors about the sellers? FORTUNE asked the research firm Interactive Data to track the performance of new issues brought out by the 30 underwriters that managed or co-managed ten or more issues in 1983. The data show that only one underwriter brought out more winners than losers: Chicago's William Blair & Co. The second- and third-ranked underwriters—Colorado's Blinder Robinson and Robinson-Humphrey, an American Express subsidiary in Atlanta—batted only .500. Shares underwritten by Wall Street's Merrill Lynch and L.F. Rothschild and San Francisco's Montgomery Securities turned in some of the worst performances. Even blue-chip underwriters such as Morgan Stanley and Lehman Brothers fared poorly.

Interactive Data followed the price changes from the day the new issues came out until September 1984. It ranked underwriters by the median performance of their issues. As Standard & Poor's index of 500 stocks rose 17%, the price of the median new issues of all but three underwriters fell.

BARRY ROOT

Most Successful Underwriters

	NUMBER OF NEW ISSUES	MEDIAN PRICE CHANGE
William Blair	10	+24%
Blinder Robinson	13	0%
Robinson-Humphrey	13	0%
Bear Stearns	11	− 4%
Drexel Burnham	19	− 5%

Least Successful Underwriters

	NUMBER OF NEW ISSUES	MEDIAN PRICE CHANGE
Montgomery	12	−45%
Dain Bosworth	10	−34%
Merrill Lynch	33	−32%
L.F. Rothschild	37	−29%
Prudential-Bache	35	−29%

SOURCES: GOING PUBLIC, INTERACTIVE DATA

Under the Weather

Securities firms turned 888 private companies into public ones last year. But the underwriters don't have much to crow about: most of the new stocks performed dismally.

Overzealous pricing of the new stocks contributed to their dismal performance. To win clients, many underwriters promised to bring stocks out at prices much higher than earnings prospects justified. Says Fred Joseph, a Drexel Burnham Lambert executive: "Sometimes it was easy to fall for your own B.S." William Blair says its new issues did well because it priced them conservatively. Pricing is an underwriter's nightmare. If the stock drops, investors complain. If it rises fast, the company going public misses out on millions in capital. The ideal, say most underwriters, is for a stock to climb about 10% after it comes out, and then rise steadily with the company's earnings.

William Blair also scored by keeping away from high-tech stocks. Blair underwrote office supply companies, including such pedestrian winners as Guilford Industries (up 168%) and ACCO World (up 61%). Guilford, based in Maine, makes fabrics for office wall dividers. ACCO World is a Chicago maker of paper clips and report folders.

One-quarter of 1983's initial offerings were for medical companies. Health maintenance organizations (HMOs), which manage groups of physicians, were particularly hot. Bear Stearns brought out HealthAmerica, a Tennessee-based operator of 30 outlets whose stock has soared 318%. D.H. Blair's new issues had a rough year, but the firm still brought out one of the best-performing companies: Staar Surgical of California. The company has a new artificial lens for cataract patients; its stock shot up 636%.

Some of the worst issues were for computer companies. Last year almost any company with a connection to high tech could be brought out at a hefty multiple. But most failed to live up to their promise. Merrill Lynch brought out Trilogy, the company founded by ex-IBM whiz Gene Amdahl, which recently abandoned plans for a high-speed mainframe computer; the stock tobogganed 88%. L.F. Rothschild underwrote TeleVideo Systems (down 74%), and Montgomery Securities co-managed Fortune Systems (down 84%). Both companies got caught in the personal computer shakeout.

The poor showing of the 1983 new issues has made this year's market much more conservative. Capital raised so far is running 68% below 1983's record $12.6 billion. Not as many companies are going public, and those that are seem modestly priced. Says Joseph of Drexel Burnham: "It's an overreaction to an overreaction." Still in vogue are medical stocks and, yes, even some new computer companies. **— Brian Dumaine**